DEPARTMENT OF STATE REVENUE

04-20120209.LOF

Letter of Findings: 04-20120209
Sales and Use Tax
For the Tax Years 2008 through 2010

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ISSUES

I. Sales and Use Tax – Software Maintenance Agreements.

Authority: IC § 6-2.5-1-1; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-4-1; IC § 6-8.1-3-3; Carroll County Rural Elec. Mem. Co-op. v. Indiana Dep't of State Revenue, 733 N.E.2d 44 (Ind. Tax Ct. 2000); Maurer v. Indiana Dep't of State Revenue, 607 N.E.2d 985 (Ind. Tax Ct. 1993); Letter of Findings 04-20100606 (August 12, 2011); Letter of Findings 04-20100311 (June 29, 2011); Letter of Findings 05-0438 (August 11, 2006); Letter of Findings 02-0086 (October 22, 2004); Sales Tax Information Bulletin 2 (December 2006); Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 2 (November 2000).

Taxpayer protests the assessment of sales and use tax paid on its purchase of computer software maintenance agreements.

I. Sales and Use Tax – Document Scanning Service.

Authority: IC § 6-2.5-3-2; 45 IAC 2.2-4-2.

Taxpayer protests the assessment of use tax on transactions where a third party scanned Taxpayer's legal documents onto compact discs.

STATEMENT OF FACTS

Taxpayer is an Indiana law firm. The Indiana Department of Revenue ("Department") conducted a sales and use tax audit of Taxpayer for the years 2008, 2009, and 2010. As a result of the audit, the Department found that Taxpayer had purchased certain tangible personal property without paying sales tax on the purchases or accruing and remitting use tax on the use of the items in Indiana. The Department therefore assessed Taxpayer additional use tax and interest on items in various categories such as catered food, office and computer supplies, accommodations, rental of tangible personal property, soft drinks, newspaper and magazine subscriptions, etc. Taxpayer protested the assessment of use tax on two categories of transactions: (1) transactions with a third-party Taxpayer hired to scan certain of its documents onto compact discs ("CDs"), and (2) Taxpayer's purchase of software maintenance agreements. An administrative hearing was held on Taxpayer's protest and this Letter of Findings ensues. Additional information will be supplied as required.

I. Sales and Use Tax – Software Maintenance Agreements.

DISCUSSION

Taxpayer protests the assessment of use tax on its purchase of software maintenance agreements.

The Department's audit states:

> Software maintenance agreements were also purchased during the sample period. The agreements reviewed routinely included software updates which enabled the software to continue to be functional and a viable product for the vendor. The vendor's unitary charge for the updates and maintenance support was not divisible, and as a result these software agreements were taxable in their entirety. The taxpayer was asked to provide some maintenance contracts that were not available with the initial review of the invoices. These contracts were not provided, therefore an assumption was made that these contracts were taxable. These contracts are taxed per audit following Information Bulletin #2 which states that optional warranties and maintenance agreements are subject to tax if the agreement includes a charge for property periodically supplied.

Pursuant to IC § 6-2.5-2-1, a sales tax, known as state gross retail tax, is imposed on retail transactions made in Indiana unless a valid exemption is applicable. Retail transactions involve the transfer of tangible personal property.

> An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction. IC § 6-2.5-3-2(a) (Emphasis added).

Indiana provides that a person is a retail merchant making a retail transaction when he engages in selling at retail. A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he acquires tangible personal property for the purpose of resale and transfers that property to another person for consideration. IC § 6-2.5-4-1 states:

> (a) A person is a retail merchant making a retail transaction when he engages in selling at retail.
> (b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:

(1) acquires tangible personal property for the purpose of resale; and

(2) transfers that property to another person for consideration.

A complementary excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction. IC § 6-2.5-3-2.

Pursuant to IC § 6-2.5-3-1 "use" and "storage" are defined as:

(a) "Use" means the exercise of any right or power of ownership over tangible personal property.

(b) "Storage" means the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana.

Pursuant to IC § 6-2.5-2-1, Indiana law specifically references pre-written computer software in the definition of tangible personal property. IC § 6-2.5-1-27 provides:

"Tangible personal property" means personal property that:

(1) can be seen, weighed, measured, felt, or touched; or

(2) is in any other manner perceptible to the senses. The term includes electricity, water, gas, steam, and prewritten computer software.

However, under Indiana law, the provision of services does not constitute the transfer of tangible personal property. Therefore, transactions which involve the provision of services are not subject to the imposition of the sales and use tax unless the law specifically defines the provision of a particular service as a taxable retail transaction.

Some "bundled transactions" involve the provision of both tangible personal property and services. A "unitary transaction" is a hybrid sale involving the provision of both tangible personal property and services for one price. A "unitary transaction" is defined at IC § 6-2.5-1-1(a) as follows:

"[U]nitary transaction" includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated.

Pursuant to this statutory definition, services are subject to the sales and use tax when they are provided in conjunction with tangible personal property – such as computer software – as a unitary transaction.

Taxpayer protests that it is not subject to use tax on purchases of software maintenance agreements it entered into with various vendors. Taxpayer makes several arguments in support of its protest.

Taxpayer argues that the sales and use tax is imposed on the retail sale of tangible personal property which does not include optional maintenance service contracts. The contracts, Taxpayer argues, are "intangible property" and therefore not subject to sales and use tax. Taxpayer cites to Maurer v. Indiana Dep't of State Revenue, 607 N.E.2d 985 (Ind. Tax Ct. 1993) for the proposition that the "sale of an intangible where a tangible personal property may later be provided is not subject to sales tax." Taxpayer also cites to Letter of Findings 02-0086 for the proposition that when a taxpayer purchases a software maintenance agreement it has "merely purchased an intangible right."

Taxpayer's reference to Maurer is misplaced. That case dealt with a charity's raffle of a car and whether the purchaser of the winning ticket or the charity that purchased the vehicle to offer as a raffle prize was responsible for the sales or use tax due on the transfer. The Maurer court decided that the retail transaction was when the charity purchased the vehicle from the dealer and therefore the charity, but for being exempt as a not-for-profit, would have been responsible for paying the sales tax. The purchaser of the raffle ticket had merely "bought a raffle ticket which was a representation of an intangible right to win a prize on the happening of a contingency." Maurer, 607 N.E.2d at 990. The software maintenance agreements that are the subject of this protest are not "an intangible right to win a prize on the happening of a contingency." The agreements represent the assumed provision of tangible personal property in the course of rendering maintenance services to Taxpayer. Also, there are only two parties to the agreement in the instant protest, and, but-for, the charity's exempt status, it would have been liable for sales tax.

As for Letter of Findings 02-0086, the tax years at issue were 1998 and 1999 and the protests and Letter of Findings relied on a version of Sales Tax Information Bulletin 2 not relevant to the analysis for the years at issue in this protest (this point will be further discussed below).

Taxpayer refers also to the treatment of this issue by other states. While the authority cited by Taxpayer could provide guidance in the instant case, none of it is binding on Indiana.

Taxpayer then cites to two additional Letters of Findings, 04-20100606 and 04-20100311, which Taxpayer argues are directly on point. These two Letters of Findings also refer to two versions of Sales Tax Information Bulletin 2 and their applicability to the taxpayers whose protests were addressed in those final determinations. However, those Letters of Findings deal with service maintenance contracts and not the types of software update agreements at issue in this protest.

Taxpayer points to Sales Tax Information Bulletin 2 as "outlin[ing] the position of the Legislature and the Department regarding optional maintenance agreements." An earlier version of Information Bulletin 2 stated as follows:

Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax. Any parts or tangible personal property supplied pursuant to this type of agreement are subject to use tax. Sales Tax Information Bulletin 2 (May 2002), 25 Ind. Reg. 3595

(Emphasis added) (See also Sales Tax Information Bulletin 2 (November 2000), 24 Ind. Reg. 1192, "Optional warranties and maintenance agreements that only contain the intangible right to have property supplied and there is no certainty that property will be supplied are not subject to sales tax.")

Taxpayer also points to Sales Tax Information Bulletin 2 (December 2006) 20100804 Ind. Reg. 045100497NRA, as further clarification on the question of whether maintenance agreements were subject to sales tax.

Optional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are subject to sales tax if there is a reasonable expectation that tangible personal property will be provided. Any parts or tangible personal property supplied pursuant to this type of agreement are not subject to sales or use tax. The supplier of the parts or property to this type of agreement is not liable for the use tax on the parts or property because the supplier is using the material to fulfill the service called for by the terms of the warranty or maintenance agreements. (Emphasis added).

Although the 2006 Bulletin represents a purported change in the interpretation of the imposition statute, Taxpayer correctly points out that the Sales Tax Information Bulletin 2 (December 2006), was not published in the Indiana Register until August 2010 and was not effective until that date.

The previous 2002 version of the Information Bulletin did not require the vendor to collect sales tax on the sale of the extended warranties and maintenance agreements; however, the vendor was required to self-assess use tax on any parts supplied pursuant to the terms of the warranty or maintenance agreement. The subsequent 2006 version of the Information Bulletin essentially reversed that requirement. The vendor was required to collect sales tax on the sale of the warranty but was not required to self-assess use tax on any parts supplied pursuant to the terms of the warranty. Presumably the subsequent version of Sales Tax Information Bulletin 2 (2006) was a "change in the department's interpretation of a listed tax" as described in IC § 6-8.1-3-3 and triggered the Department's obligation to either adopt a regulation or publish notice of that "change" in the Indiana Register.

However the Department must point out that prior to the issuance of the Sales Tax Information Bulletin 2 (December 2006), the Department issued Letter of Findings 05-0438 (August 11, 2006), 20061101 Ind. Reg. 045060474NRA, in which the Department addressed the question of under what circumstances "Software Maintenance Agreements" were subject to sales tax. In the protest at issue in the 2006 Letter of Findings, the Department found that the particular agreements were subject to sales tax on a "prospective basis" as follows:

There is no regulation that sets out the department's position regarding the application of sales and use tax to optional warranties. The department first issued Sales Tax Information Bulletin [] 2 concerning Optional Warranties... on May 2, 1983. In that Information Bulletin, the department explained that if there was a possibility that no tangible personal property would be transferred with the warranty, then there was no certainty that there would be a retail sale and the sales and related use tax did not apply. This position was restated in the revised Sales Tax Division Information Bulletins issued in August 1991, November 2000, and May 2002. Each of the revisions restated the general rule. In the May 2002 revision, it was stated "[o]ptional warranties and maintenance agreements that contain the right to have property supplied in the event it is needed are not subject to sales tax." Each of the revisions also gave a specific example concerning computer software situations. The examples stated that sales and use tax would apply to the sale of an optional warranty or maintenance agreement in the software situation only if there was a guarantee of the transfer of tangible personal property (updates) pursuant to the agreement.

Computer technology and use has evolved since the issuance of the first Sales Tax Information Bulletin [] 2 on May 2, 1983. Almost all software optional warranties and software maintenance agreements sold today include the automatic provision of updates-sometimes on a day-by-day or week-by-week basis. Purchasers of these agreements have a reasonable expectation that they will receive the updates whether or not the actual contract couches the provision of updates as "optional." The substance of the agreements is that tangible personal property in the form of software updates will be provided no matter what the language of the contract says. The department determines tax consequences by construing the substance of the agreement over the form. Wholesalers, Inc. v. Indiana Department of State Revenue, 597 N.E.2d 1339 (Ind. Tax 1992). In the case of software maintenance agreements or optional warranties, it is clear that the parties presume that tangible personal property in the form of updates will be transferred. Therefore, **the department will construe software maintenance agreements and optional agreements as presumed to be subject to the sales and use tax.** A taxpayer could rebut this presumption by demonstrating that no updates were actually received pursuant to a particular maintenance agreement or optional warranty.

In this particular taxpayer's situation, the department will apply this interpretation prospectively. (Published in the Indiana Register and available at http://www.in.gov/legislative/iac/20061101-IR-045060474NRA.xml.html) (**Emphasis added**).

Letter of Findings 05-0438 did not find that all software maintenance agreements were subject to sales tax but clarified the standard under which the Department would attempt to discern which maintenance agreements represented unitary transactions subject to tax and which agreements provided only exempt services and were not subject to tax. The Letter of Findings did so recognizing the complexity of the software vendors' densely written agreements and recognizing the increasingly common practice by which software "updates" were routinely

and regularly provided under such agreements. The Letter of Findings recognized the proposition that the prior standard by which decisions were reached was increasingly unsatisfactory to both the Department and the affected taxpayers.

As of the publication of Letter of Findings 05-0438, the Department fulfilled its obligation under IC § 6-8.1-3-3(b)(2) to give notice of its "change of interpretation" concerning the taxability of software maintenance agreements. As summarized in the Letter of Findings, "The taxpayer's protest is sustained as to the maintenance agreements and optional warranties in this assessment. The taxpayer is advised that in the future, there will be a rebuttable presumption that all software maintenance agreements and optional warranties will be subject to the sales and use taxes."

In the case of the software maintenance agreements, the interpretations set out in the Sales Tax Information Bulletins are irrelevant. Instead the interpretation set out in the August 2006 Letter of Findings governs the issue. The publication of that Letter of Findings met the requirements set out in IC § 6-8.1-3-3. See Carroll County Rural Elec. Mem. Co-op. v. Indiana Dep't of State Revenue, 733 N.E.2d 44, 49 n.5 (Ind. Tax Ct. 2000) ("The publication of the Letter of Findings is a prerequisite for the Department before it can change its position as to the interpretation of a tax, where the change would increase the taxpayer's liability.")

The Department is not required to discern whether the maintenance agreement vendors did or did not provide Taxpayer with computer software updates or whether the underlying agreement guaranteed that updates would be provided. The Department presumes that updates were provided pursuant to the agreements.

The software maintenance agreements for which Taxpayer seeks a refund contain language which – as typical in such agreements – does not definitively establish whether or not Taxpayer would or would not receive software updates. However, the Department does point out that the language in some of the agreements actually reads as follows: "free updates as they become available"; and "free upgrades as they become available" which reinforces the point that software updates and upgrades are routinely provided under such agreements.

The software maintenance agreements at issue provide for certain computer services and – under certain circumstances – computer software in the form of updates, upgrades, patches, fixes, versions, modifications, releases, corrections, and enhancements all of which constitute "tangible personal property" under IC § 6-2.5-1-27. If the "software updates" are provided in conjunction with the accompanying services, the maintenance agreements represent unitary transactions all of which are subject to sales tax under IC § 6-2.5-4-1(e).

Taxpayer has provided no information establishing that software updates were not provided pursuant to the agreements it has with its vendors. Without knowing whether or not tangible personal property was transferred pursuant to its vendor agreements, Taxpayer's protest must be denied.

FINDING

Taxpayer's protest is respectfully denied.

I. Sales and Use Tax – Document Scanning Service.

DISCUSSION

The second category of transactions on which Taxpayer protests the imposition of use tax are itemized payments Taxpayer made to an Illinois company that scanned Taxpayer's litigation documents onto CDs.

Taxpayer explains, "as detailed in the enclosed invoices, not only were these charges solely for services, they were charges for services provided in Illinois, not Indiana." Taxpayer cites to 45 IAC 2.2-4-2(a) in support of its protest.

As a preliminary matter, the statement of law under Issue I is incorporated into this section, except for the specific references to pre-written software and software maintenance agreements.

The regulation to which Taxpayer cites, 45 IAC 2.2-4-2(a), generally states that services with respect to property not owned by the person rendering the service are not considered transactions of a retail merchant constituting selling at retail and are therefore not taxable. 45 IAC 2.2-4-2(a) does, however, qualify that if, along with rendering services, a serviceperson also transfers tangible personal property for consideration, that transaction is the transaction of a retail merchant selling retail and therefore potentially subject to tax unless certain conditions are met. The conditions are (1) if the serviceperson is in an occupation that primarily provides services, (2) if the tangible personal property purchased is used or consumed as a necessary incident to the service, (3) the price charged for the tangible personal property is inconsequential – meaning less than 10 percent of the service charge, and (4) the service provider paid sales tax when it purchased the tangible personal property, then, and only then, are the charges not subject to sales and use tax.

45 IAC 2.2-4-2(a) states:

> (a) Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax. Where, in conjunction with rendering professional services, personal services, or other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:
>
> (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;

(2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
(3) The price charged for tangible personal property is inconsequential (not to exceed 10[percent]) compared with the service charge; and
(4) The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition.
(Emphasis added).

Taxpayer argues that any transfer of property in the rendition of the scanning services is inconsequential and below the requisite 10 percent ceiling stated in the cited regulation. Taxpayer is incorrect. According to the itemized invoices provided by Taxpayer, the Illinois service provider charged Taxpayer for various services such as "litigation imaging," "file naming," and "bookmarking in Adobe." However, these invoices also show that Taxpayer was charged for CDs. CDs are tangible personal property. Furthermore, the itemized charges for these CDs are a higher percentage of the total service charge than the "inconsequential" 10 percent referenced in the regulation to which Taxpayer cites. The Department's audit only subjects the charges relating specifically to the CDs to use tax, not the other charges relating to what are clearly services.

Up to this point the Department's audit treatment is correct. However, the Department's audit, as expressed in the audit summary report, did not establish that these CD's were "used, consumed, or stored" in Indiana pursuant to the requirements of Indiana's use tax imposition statute, IC § 6-2.5-3-2. The invoices Taxpayer provided show that the charges at issue were billed to Taxpayer's office in Illinois.

Absent a specific assertion in the audit summary report that the CDs were actually used in Indiana, the Taxpayer is correct that the CDs are not subject to Indiana use tax.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of use tax assessed on software maintenance agreements is respectfully denied.

Taxpayer's protest of use tax assessed on CDs provided pursuant to scanning services provided by an Illinois vendor is sustained.

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